Supreme Court, U.S.
FILED

981736 APR 29 1999

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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1999

DONALD M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION, and
JOHN S. NADOLSKI,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In light of the over 500 reported cases which have applied the concept of "loss causation"[1] in the securities fraud context, the academic and judicial recognition of widespread confusion concerning that concept among the Circuits, and the Supreme Court's silence on the subject, should the Sixth Circuit be allowed to add to the existing confused state of the law by holding, in conflict with decisions of other Circuits, that loss causation is not established even though: securities fraud was committed by misrepresentation of investment risk in face-to-face negotiations, the misrepresentation induced the victim to assume a risk he would have otherwise shunned, the parties were in privity, and the loss suffered was due to the materialization of the risk which was misrepresented.

In light of the policy of the securities law to deter securities fraud, should misapplication of the concept of "loss causation" be allowed to produce a judicial ratification of the felonious taking and retention of a $3.7 million profit by a company whose president was criminally convicted of the fraud in question?

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[1]Since the concept of "loss causation" is now in use in securities fraud litigation in all circuits, it may safely be said that it is a consideration in every securities fraud case or controversy involving damages. Thus the impact of the doctrine is potentially on thousands of disputes.

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT BELOW

Petitioner

Donald M. Rowe

Respondents

Marietta Corporation and John S. Nadolski. The corporation has no parent company or non-wholly owned subsidiaries.

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OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Sixth Circuit is included in the Appendix at Appendix A at 1a. The Opinion of the District Court for the Western District of Tennessee is included in Appendix B at 22a. The District Court ordered entry of the final judgment on June 6, 1997. It is printed in Appendix D at 119a.

JURISDICTION

The United States Court of Appeals for the Sixth Circuit issued its Opinion on January 6, 1999. On January 19, 1999, Petitioners filed a Petition for Rehearing and Suggestion for Rehearing *En Banc* which the United States Court of Appeals denied on February 9, 1999 (Appendix C at 117a). This Petition for Writ of Certiorari is filed within 90 days of the denial of the Petition for Rehearing. The Court's jurisdiction is invoked pursuant to 28 U.S.C. §§1254(1) and 2106.

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, RULES AND REGULATIONS INVOLVED

15 U.S.C. §78j(b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or

instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

15 U.S.C. §78t(a):

"Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

17 C.F.R. §240.10b-5:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of

the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

In 1987, the Defendant Marietta Corporation, then a publicly held company, and its President, Defendant John Nadolski, attempted to induce Plaintiff Donald M. Rowe to sell his stock representing a 90% interest in American Soap Company on terms which included a promise to share with Rowe a portion of the companies' combined future profits over a five year period (the "earnout"). Rowe declined because Marietta's lack of a business record made the earnout too risky. Between 1987 and 1989, Defendants falsified Marietta's financial reports for three fiscal years in order to make it appear that Marietta was an extremely fast growing and profitable company. In 1989 Defendants again approached Rowe. This time, Rowe agreed to sell and did sell on terms that included the earnout. In truth, however, Marietta was not the fast growing and profitable company represented,[2] and during the five-year period following Rowe's sale to Marietta, the earnout failed to produce the

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[2]"[Defendant John] Nadolski [President of Marietta Corporation] was tried and criminally convicted . . . of four violations of federal securities laws . . ." (District Court Opinion, Appx. p. 31a). "Thomas Blair . . . the Secretary-Treasurer, Chief Financial Officer, and a director of Marietta from 1987 until 1991 . . . admitted to embezzl[ement] and pled guilty to illegally moving [money] in interstate commerce . . . and to conspiring to commit perjury . . ." (District Court Opinion, Appx. p. 30a).

expected profit. Rowe's 90% interest in American Soap was worth $13,654,008, but, because the earnout failed, Rowe was paid only $9,941,044. Notwithstanding Rowe's loss and the Defendants' gain by the difference, $3,712,964, the Sixth Circuit denied Rowe relief on the ground that he had failed to prove "loss causation."

The District Court had original jurisdiction pursuant to 15 U.S.C. §78aa, and 28 U.S.C. §1331.

The facts are stated in the words of the Sixth Circuit and the District Court as follows:

> "Several negotiations had occurred prior to the 1989 sale. In 1987, [Defendant] Marietta proposed a purchase deal that included a substantial amount of Marietta stock and an "earnout" provision. The earnout provision required that Rowe accept, as partial consideration for the sale of his business, a percentage of the profits of the merged corporation over a period of years. The provision's structure, however, granted Rowe only a percentage of the profits above certain earnings thresholds, set higher for each succeeding year. If the merged corporation's earnings failed to meet that threshold, Rowe would receive nothing from

the provision. Thus, the earnout provision entitled Rowe to the conditional right to a percentage of profits, with the risk factor that the outcome was contingent upon the merged corporation's success in the marketplace.

Rowe declined to sell in 1987 because Marietta had no real business record. Rowe lacked confidence that the risk in accepting such consideration was worthwhile. As Marietta's reports began showing increased earnings, Rowe's confidence also increased. Marietta presented increases in net sales between 1986 and 1987 of 33.37 percent and 53.5 percent between 1987 and 1988; it also represented that profitability had grown by 42.41 percent between 1986 and 1987 and 36.61 percent between 1987 and 1988. However, these representations were false. Over three years, Marietta overstated its net income by $1.7 million, or 37 percent." (Sixth Circuit Decision, Appx. p. 3a.)

"[Marietta's President] Nadolski and [Marietta's Treasurer] Blair caused the creation of $1,000,000 in fraudulent sales for the quarter [ending just prior to the March 10, 1989 transaction with Rowe] . . . Had

Marietta not overstated sales by $1,000,000, the company would have posted a $297,000 net loss for the quarter. Additionally, based on the $1,000,000 fraudulent inflation of its sales for the first quarter of fiscal 1989, Marietta posted earnings per share for that quarter of $0.23. Marietta's real sales for the first quarter of fiscal 1989 would have generated an actual loss of $0.14 per share." (District Court Decision, Appx. p.35a.)

"Despite having refused to sell on the 1987 terms, Rowe accepted very similar terms in 1989 after Marietta's [fraudulently inflated] profit figures added confidence that the risk was attractive. As consideration for Rowe's 90% stock of ASC, Rowe received five components . . . [Component 4 was the] right to contingent payments under the 'earnout,' based on one-half of all ASC's glycerine net earnings, and one-half of all soap business profits of ASC and Marietta before interest and taxes over fixed thresholds; . . ." (Sixth Circuit Decision, Appx. pp. 3a-4a)

"Rowe's loss resulted from the failure of Marietta to earn beyond the thresholds

established under the earnout clause." (Sixth Circuit Decision, Appx. p. 14a)

The value of Rowe's 90% interest in American Soap Company was $13,654,008 (Sixth Circuit Decision, Appx. p. 8a).

There were five (5) components of consideration to be paid to Rowe. The value paid by Defendants pursuant to components 1, 2, 3 and 5 totaled $9,871,168.[3] (Sixth Circuit Decision, Appx. pp. 3a-4a). The only amount paid by the Defendants under component 4, the earnout, was $69,876 (Sixth Circuit Decision, Appx. p. 12a). Therefore, the total paid by Defendant-fraud-feasors to Rowe for his 90% interest in American Soap Company was $9,941,044.

The value received by the Defendant fraudfeasors and given up by Rowe (90% share of American Soap Company) was $13,654,008. The amount the fraudfeasors paid Rowe was $9,941,044. The difference was $3,712,964. The Sixth Circuit's decision rewards the Defendants' fraud by that amount, $3,712,964, plus interest, and deprives

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[3] 1. $4,827,310 unallocated cash
2. $1,350,000 cash for non-compete agreement
3. $1,884,716 present value of note
5. $1,809,142 value of Marietta shares
$9,871,168 (Sixth Circuit Decision, Appx. pp. 4a, 8a)

Rowe of that amount. Rowe was not returned to the *status quo ante*.

The Defendants were allowed to profit from their fraud despite the fact that the risk which was misrepresented was the same risk that materialized. The Sixth Circuit held that "loss causation" had not been established under these facts.

ARGUMENT FOR GRANTING THE WRIT

There are over five hundred reported case law references in the Westlaw federal securities law database to the concept of "loss causation." The judicial formulations and applications of this concept vary widely. See, e.g., Kaufman, *Loss Causation: Exposing A Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357 (1991); Fisher, *The Analyst - Added Premium in Open Market Securities Fraud Cases*, 52 BUS. LAWYER 35, at 52-54 (1997).[4] Judge

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[4]"Many . . . decisions recognize that 'loss causation' is an element of a Rule 10b-5 case. [McGonigle v. Combs, 968 F.2d 810, 820 (9th Cir. 1992); Arthur Young & Co. v. Reves, 937 F.2d 1310, 1327-28 (8th Cir. 1991); Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989); Harris v. Union Elec. Co., 787 F.2d 355, 367 (8th Cir. 1986)] Articulations of this element differ. Some courts call the requirement one of 'proximate cause,' asserting that the

(continued...)

Posner has questioned whether the term "loss causation" advances understanding at all. Bastian v. Petren Resources Corp., 892 F.2d 680, 685-86 (7th Cir. 1990). "There remains substantial disagreement, both implicit and explicit, among the Circuits as to the proper approach to securities causation," Steckman and Conner, *Loss Causation Under Rule 10b-5, A Circuit-By-Circuit Analysis: When Should Representational Misconduct Be Deemed the Cause of Legal Injury Under the Federal Securities Laws?* 1061 PLI/Corp 375, 504 (1998). See generally, Georgakopoulos, *Frauds, Markets, & Fraud-On-The-Market: The Tortured Transition of Justifiable Reliance From Deceit to Securities Fraud*, 49 U. Miami L. Rev. 671 (1995) (noting substantial confusion in the case law).

(...continued)
misrepresentation or omission must 'touch . . . upon the reasons for the investment's decline in value.' [Huddleston v. Herman & MacLean, 640 F. 2d 534, 554-55 (5th Cir. 1981)] Other courts refer to the 'nexus between the defendant's fraudulent conduct and the plaintiff's pecuniary loss,' [Harris v. Union Elec. Co., 787 F. 2d 355, 367 (8th Cir. 1986)] while still others explain loss causation to mean that 'the damage complained of [was] a foreseeable result of the plaintiff's reliance on the fraudulent misrepresentation.' [Weiss v. Wittcoff, 966 F. 2d 109, 111 (2d Cir. 1992); Klein v. Boyd, {1996-1997 Transfer Binder} Fed. Sec. L. Rep. (CCH) P. 99,352, at 96,176 (E.D. Pa. Nov. 18, 1996). Fisher, *id* at 52.

Judge Easterbrook has called the terms "loss causation" and "transaction causation" "confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws." LHLC Corp. v. Cluett, Peabody & Co., Inc., 842 F. 2d 928, 931 (7th Cir. 1988), cert. denied, 488 U.S. 926 (1988). Judge Frankel, while he thought that the labels "may prove eventually to be useful," was "not convinced at this time that the Circuit ought to be committed to their employment or to their still uncertain implications." Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374, 384 (2d Cir., concurring opinion), cert denied, 421 U.S. 976 (1974).

Notwithstanding these judicial reservations, there is now widespread use of the concept in securities fraud cases. Despite the "substantial disagreement" among the Circuits, the Supreme Court has never provided guidance as to the proper application and meaning of the loss causation concept.

The Sixth Circuit's instant decision puts that Circuit in conflict with numerous other Circuits, adding to the confusion in the case law. Furthermore, this Court has repeatedly noted that the intent of the securities laws is to deter fraud. Randall v. Loftsgaarden, 478 U.S. 647, 664, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151, 155,

92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 US 6, 12 (1971). In direct contradiction of the statutory intent to deter securities fraud, the Sixth Circuit's misapplication of the concept of loss causation has made it a shield for fraud, allowing the defendant fraudfeasors to profit by $3.7 million, even though Defendant Nadolski, President of Defendant Marietta, was criminally convicted for the same fraud.

The Sixth Circuit held that even though Mr. Rowe was in direct privity with the Defendants and was the victim in face-to-face negotiations of fraudulent misrepresentations which induced him to enter into a transaction he would otherwise shun because of the risk, and even though his loss resulted from the materialization of the same risk that was misrepresented, he failed to prove "loss causation." In so holding, the Sixth Circuit decision is in conflict with decisions of the Second, Fifth, Seventh, Eighth, Ninth and Eleventh Circuits. Those Circuits hold that where securities fraud induces a party to enter into a transaction he would otherwise avoid because of its riskiness -- and the loss results because the risk misrepresented materializes, and/or where there is fraudulent inducement in a transaction involving privity, that "loss causation" is established.

The cases which conflict with the Sixth Circuit's decision include Bastian v. Petren Resources Corp., 892 F. 2d 680, 685-86 (7th Cir. 1990); Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989); Marbury Management, Inc. v. Kohn, 629 F. 2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Chasins v. Smith, Barney & Co., Inc., 438 F. 2d 1167, 1173 (2d Cir. 1970); Huddleston v. Herman & MacLean, 640 F. 2d 534, 554-55 (5th Cir. 1981); In Re: Letterman Brothers Energy Securities Litigation, 799 F. 2d 967, 972 (5th Cir. 1986); Garnatz v. Stifel, Nicholas & Co., Inc., 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978); Harris v. Union Electric Co., 787 F. 2d 355 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); In re: Control Data Corp. Securities Litigation, 933 F. 2d 616, at 618-621 (8th Cir.), *cert. denied*, sub nom., 502 U.S. 967 (1991); Arthur Young & Co. v. Reves, 937 F. 2d 1310, 1332 (8th Cir. 1991), aff'd sub nom., 507 U.S. 107; and Hatrock v. Edward D. Jones & Co., 750 F. 2d 767, 773 (9th Cir. 1984).

The purpose of the "loss causation" rules is to prevent recovery of damages in suits based on misstatements in securities offerings which did not actually cause harm. A decision for Rowe in this case would be consistent with that purpose. In Rowe's case, there was a fraudulent inducement by misrepresentation of the risk involved, and the loss resulted from suffering the consequences of the same risk which was misrepresented: "Despite having refused to sell

on the 1987 terms, Rowe accepted very similar terms in 1989 after Marietta's [fraudulent] profit figures added confidence that the risk was attractive." (Sixth Circuit Decision, Appx. pp. 3a-4a). "Rowe's loss resulted from the failure of Marietta to earn beyond the thresholds established under the earnout clause." (Sixth Circuit Decision, Appx. p. 14a)

This case is a particularly fine vehicle for resolving the existing conflicts among the Circuits. Because the fraud in this case was perpetuated in face-to-face negotiations, there was direct reliance, privity, and the investment risk misrepresented was the same risk that materialized,[5] there is no danger that resolution of this case in Rowe's favor will open a Pandora's box of strike suits. This case fits the example given in Judge Posner's carefully crafted opinion in Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990).

Judge Posner's opinion in Bastian is considered one of the leading decisions on "loss causation." Bastian makes

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[5]Although neither the District Court nor the Sixth Circuit accepted Defendants' claim of waiver (obviously neither would have reached the loss causation issue if they had), since it is mentioned in the Sixth Circuit opinion an explanation and the record citations showing there was no waiver are provided in Appendix F, p. 124a, *et seq.*

it clear that where, as here, the risk misrepresented is the risk which materialized, loss causation is established. In that case, Judge Posner reasoned that a securities fraud plaintiff should have to show that the loss suffered was a result of the fraud perpetrated. Losses attributed to external forces unrelated to the risk misrepresented would not be recoverable. In conflict with the Sixth Circuit, Bastian recognized that recovery is proper when an investor was fraudulently induced to take a risk, and the risk misrepresented was the risk that materialized:

> "Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case . . . is therefore consistent with nonliability in a case such as the present." 892 F. 2d at 685-86.

The Eleventh Circuit's decision in Bruschi v. Brown, 876 F.2d 1526 (11th Cir. 1989) is also among those which conflict with that of the Sixth Circuit. It involved fraudulent inducement to purchase securities. An investment advisor

recommended purchase of securities that were unsuitably risky for a client and in which he had an undisclosed financial interest. According to the Eleventh Circuit, loss causation is established when "a defendant induces a plaintiff to enter into a risky transaction by misrepresenting it as safe and the plaintiff suffers a loss resulting from the risky nature of the investment." *id.* at 1531. This is precisely what happened in this case. Defendants misrepresented fundamental elements of Marietta's performance, to-wit: they falsely portrayed Marietta as a fast growing company with an outstanding record of spectacularly increasing profits. That went to the heart of the earnout which was based on the future profits of the combined company. In such a circumstance -- where plaintiff assumes a substantially riskier investment than he agreed to undertake, and the loss results from the materialization of that risk -- plaintiff satisfies the causation requirement and is entitled to recover damages to make him whole.

The Sixth Circuit's opinion also conflicts with the Second Circuit decision in Marbury Management, Inc. v. Kohn, 629 F. 2d 705 (2d Cir. 1980). In Marbury, a trainee at a brokerage firm fraudulently misrepresented himself as a "lawfully licensed registered representative." An investor acted in reliance on the trainee's advice, believing that advice to have been provided by an experienced broker. The Second Circuit held that the trainee's fraudulent

misrepresentation was the "legal cause of the loss" for which the investor should be allowed recovery. *Id.* at 708. Investors who rely on the experience of a broker but are defrauded because that broker is merely a trainee are taking a much greater risk than they thought and are entitled to recover damages for their loss.

In Garnatz v. Stifel, Nicholas & Co., Inc., 559 F.2d 1357, 1360 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978), the Eighth Circuit also recognized that the proper measure of damages in a case involving misrepresentations of the degree of risk is the rescissory damage measure which "seeks to return the parties to the *status quo ante* the sale."

The above cases have been acknowledged by distinguished commentators to embody correct application of loss causation principles. The commentators have noted that where an investor has been induced, through representational misconduct, to accept unwanted risk, reliance on misrepresentations or material omissions should constitute a sufficient causal link between the misrepresentation and legal loss:

> "If the plaintiff would not have purchased the stock, had the truth been known, then a court should not charge her with any losses from the investment. Under these circumstances the fraud induced the plaintiff to accept risks

> that she would not have chosen otherwise. . . . If a fraudulently overstated prospect of gain, or a fraudulently understated risk of loss, convinces an investor to accept the total risk-return prospect offered by the investment as a whole, then that misrepresentation has induced the plaintiff to undertake the disclosed risks posed by the investment. The courts should permit the plaintiff to recover for any loss in value resulting from the occurrence of risks that she would not have accepted willingly had the misrepresentation not altered her evaluation of the total risk package." Merritt. *A Consistent Model for Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 Tex. L. Rev. 469, at 522-23 (1988).

See also Easterbrook & Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611, 648-51 (1985).

Many of these cases have arisen in situations where a broker has misrepresented the degree of risk. However, it has been pointed out that the broker cases do not constitute an exception to general securities causation jurisprudence. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 389-90 (1991)

(explaining Garnatz v. Stifel, Nicolas & Co, 559 F. 2d 1357 (8th Cir. 1977) on the grounds that the misrepresentations were "so material" as to cause plaintiff to part with the purchase price of the securities, not because the case dealt with broker dealers).

Bruschi, Bastian, Marbury and Garnatz are all consistent with the common law recognition that a substantial increase in the risk that a foreseeable event would occur is sufficient to establish proximate cause. See *Restatement of the Law, Second*, Torts 2d §281, Comm. e. See also *Restatement of the Law, Second*, Torts, §448 B, Comment b:

> "If the actor's conduct has created or increased the risk that a particular harm to the plaintiff will occur, and has been a substantial factor in causing that harm, it is immaterial to the actor's liability that the harm is brought about in a manner which no one in his position could possibly have been expected to foresee or anticipate. This is true not only where the result is produced by the direct operation of the actor's conduct upon conditions or circumstances existing at the time, but also where it is brought about through the intervention of other forces which the actor could not have expected,

> whether they be forces of nature, or the actions of animals, or those of third persons which are not intentionally tortious or criminal."

Rowe proved that by misrepresentations which increased the risk of loss from the earnout he was fraudulently induced to accept a risk that he would have otherwise have not accepted, and that the loss resulted from the materialization of that very risk. However, contrary to the above decisions and authorities, the Sixth Circuit imposed on Rowe the burden of proving 'something more' to establish "loss causation."

The Sixth Circuit does not define what more Rowe would have had to prove. Indeed, in a real world context, there was nothing more Rowe could have proven. Was Rowe required to prove that, had he known the truth, the earnout would have been negotiated to contain different terms, such as lower thresholds, and that under a different agreement, he would have earned more than the $69,876? Clearly imposing such a burden on Rowe is inconsistent with the finding that Rowe would not have entered into the transaction at all had he been told the truth.

Marietta's President, John Nadolski, and its Treasurer, Thomas Blair, were both found guilty of criminal conduct. Marietta's profits and earnings were found to have

been fraudulently inflated, and materially so. Was Rowe required to prove that if the company had actually had the spectacular growth in sales and profits that had been represented, and if it been actually been managed by two truly able top executives, that the earnout would have produced a better return? Such speculative matters are not to be imposed as an additional burden on the innocent victim. As Professor Hazen has pointed out:

> "It is absurd to place the burden of proof of such speculative matters on the injured party as opposed to the wrongdoer. There is ample support for requiring that in a fraudulent inducement case, once the plaintiff establishes that there was transaction causation, the burden shifts to the defendant that the loss was due to wholly independent factors."Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

Professor Hazen also states, consistently with the cases cited above, that "[i]n an inducement situation -- where the misrepresentation or omission induced the challenged transaction -- it is sufficient to show that plaintiff's loss was caused by the transaction." Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

Many varying approaches have been adopted by the Circuits in applying the concept of "loss causation" in the securities fraud context. Some cases have noted that where privity is involved the proper remedy for fraudulent inducement is that the victim be returned to the *status quo ante*. See Chasins v. Smith, Barney & Co., 438 F2d 1167, 1173 (2d Cir. 1970). See also In re: Letterman Securities Litigation, 799 F. 2d 967, 972 (5th Cir. 1986) and Huddleston v. Herman & MacLean, 640 F. 2d 534, 555 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983), making the "privity" distinction. As this case illustrates, where there is a face-to-face fraudulent inducement, privity, there is an increased likelihood that the party committing the fraud may directly benefit from it. Here the Defendants made a $3.7 million profit as a direct result of the commission of a felony.

Chasins v. Smith, Barney & Co., 438 F. 2d 1167, 1173 (2d Cir. 1970) held that the requirement of proof of "loss causation" is met where there was a special relationship between buyer and seller such as privity and "there was a failure to disclose material information about the underlying investment." The Rowe case meets both requirements. In Chasins, the defendant broker claimed that plaintiff was not entitled to recovery because, despite the fraud, plaintiff suffered no injury. That is, the defendant asserted that there was no loss causation since plaintiff paid the same price to defendant that he would have paid to

another broker. The Court of Appeals rejected that argument because the issue did not involve defendant's alleged manipulation of price. Rather, the impact of defendant's fraud was to induce plaintiff to enter into a transaction that plaintiff would not have entered into. In such a situation, the elements of causation are satisfied, and the remedy is to make plaintiff whole. See also Manufacturers Hanover Trust Co. v. Drysdale Securities Corp., 801 F. 2d 13 (2d Cir. 1986).

Huddleston, *supra*, is cited and relied on by the Sixth Circuit (Sixth Circuit Decision, p. 13a), however, the Sixth Circuit misapplied Huddleston. As Letterman, *supra*, explains, discussing Huddleston, the Fifth Circuit applies the Chasins approach in cases, such as Rowe's, involving privity:

> "The district court used the out-of-pocket measure of damages set out in Huddleston v. Herman & MacLean, 640 F. 2d 534, 555 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). Under Huddleston, in a Rule 10b-5 action a purchaser of securities may recover against a defendant *with whom the purchaser was not in privity* or who owed the purchaser no fiduciary duty only the 'difference between the price paid and the "real" value of the security . . . at the time of the initial

> purchase by the defrauded buyer.' Id. at 556. *** Huddleston indeed explicitly reserves the Chasins recissional measure of damages *for cases in which the purchaser and defendant are in privity* or in which the defendant owes some fiduciary duty to the purchaser. Id. at 554. In Chasins, the plaintiff had been lured into purchasing securities on the basis of misrepresentations made by a broker." (Emphasis added) 799 F. 2d at 972.

The Sixth Circuit's decision in Rowe also conflicts with the "some causal nexus" test of the Eighth Circuit. Harris v. Union Electric Co., 787 F. 2d 355 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); In re: Control Data Corp. Securities Litigation, 933 F. 2d 616, at 618-621, *cert. denied*, sub nom., 502 U.S. 967 (1991); Arthur Young & Co. v. Reves, 937 F. 2d 1310, 1332 (8th Cir. 1991), aff'd sub nom., 507 U.S. 107. In addition, it conflicts with the Ninth Circuit's decision in Hatrock v. Edward D. Jones & Co., 750 F. 2d 767, 773 (9th Cir. 1984) that a plaintiff "should not have to prove loss causation where the evil is not the price the investor paid for a security, but the [defendant's] fraudulent inducement of the investor to purchase the security."

The Sixth Circuit's decision also conflicts with American Law Institute's Federal Securities Code which defines causation in these terms:

"A loss is 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct." 1 American L. Inst., *Federal Securities Code* 56-63 (1980), Comments to §202(19).

The commentary has this to say:

"§202(19)(A): This is the language of 'causation in fact' that Restatement (Second) of Torts, §546 uses in stating the general rule on causation and deceit. As applied to the *fact* of causation alone, according to Prosser, no better test has been devised. Prosser, Torts, 240, 248 (4th Ed. 1971). The language makes it plain, for example, that if the defendant's misrepresentation was a 'substantial factor' in inducing the plaintiff to buy, the defendant is not absolved merely because other factors -- for example, the plaintiff's having recently received a large inheritance or his having been counseled to diversify his portfolio -- contributed to this result.

> §202(19)(B): To repeat, it does not follow that 'but for' causation (as defined in 'substantial factor' terms) should always establish liability. For 'but for' is at most a rule of exclusion: if it is not satisfied, clearly there can be no causation, but, even if it *is* satisfied, policy considerations other than factual causation may preclude liability. See *id.* at 238-239. These are the considerations subsumed under the question-begging but useful term, 'legal cause,'which §202(19)(B) defines in the reasonably expectancy language of Restatement (Second) of Torts §548A -- a test that, realistically, must be reviewed as a general caveat that 'but for' is not necessarily enough."

The risk that an earnout, which was based on the combined earnings of Marietta and the acquired company, would fail to produce increased profits was within the foreseeable risk of harm to Rowe which was produced by materially misrepresenting Marietta's profitability for the three fiscal years preceding the transaction. The RESTATEMENT OF TORTS, 2d §584A states that loss causation is established where the pecuniary loss is within the foreseeable risk of harm created by the misrepresentation:

"§584A. Legal Causation of Pecuniary Loss
A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance.
Comment:

A. Causation, in relation to losses incurred by reason of a misrepresentation, is a matter of the recipient's reliance in fact upon the misrepresentation in taking some action or in refraining from it. (See §546). Not all losses that in fact result from the reliance are, however, legally caused by the representation. In general, the misrepresentation is a legal cause only of those pecuniary losses that are within the foreseeable risk of harm that it creates. There is an analogy here to the rules as to legal causation of physical harm resulting from negligent conduct, stated in §§435 to 461."

The Sixth Circuit's failure to correctly apply the concept of "loss causation" may be partially explained by the lack of clear guidance by the U.S. Supreme Court, which has never spoken on the issue, and by the many conflicting formulations of the concept in the case law. The instant decision departs from correctly reasoned decisions in

other Circuits. The Sixth Circuit's decision adds to the existing confusion concerning the proper application of the concept of "loss causation."

Furthermore, as applied by the Sixth Circuit the concept has become a shield for fraud. In cases such as this, involving privity and fraudulent inducement, there is an enhanced possibility that the fraudfeasor may have profited directly from the securities fraud. In violation of the unmistakable intent of the securities laws to deter fraud, a policy which this Court has repeatedly noted,[6] the decision below rewards the Defendants' felonious conduct with a $3.7 million profit. That was a $3.7 million profit that could not have been achieved permanently without the commission of fraud and the aid of a judicial misapplication of the doctrine of "loss causation."

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[6]Randall v. Loftsgaarden, 478 U.S. 647, 664, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986) ("Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions."); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 US 6, 12 (1971).

CONCLUSION

Bruschi,[7] Bastian,[8] Marbury,[9] Garnatz,[10] the RESTATEMENT OF TORTS, SECOND, the American Law Institute's *Federal Securities Code*, Professor Hazen, and the other cases and commentators cited herein, all teach that loss causation is demonstrated where, as here, there was a fraudulent misrepresentation of the risk of a foreseeable event, and the risk misrepresented was the risk that materialized.

The existing confusion in the case law should be cleared away. This is especially necessary in light of the hundreds of securities fraud cases which have attempted, with varying success, to apply the concept, and the thousands of securities fraud disputes that are and will be affected by the "loss causation" doctrine.

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[7] Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989).

[8] Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990).

[9] Marbury Management, Inc. v. Kohn, 629 F. 2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).

[10] Garnatz v. Stifel, Nicholas & Co., 559 F. 2d 1457, 1360-1361 (8th Cir. 1997), *cert denied* 435 U.S. 951.

Certiorari should be granted both to clarify the widely used concept of "loss causation," and to resolve the differences among the Circuits.

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